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## Comrades or Competitors?: Trade Links Between China and Other East Asian Economies

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*Has China's emergence as a major exporter dampened the prospects of other Asian economies? Although many have suggested that the answer is "yes," the evidence to support such an adversarial view of trade links between China and East Asian economies is hard to come by.*

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Two paradigms help organize the evidence on China's trade linkages with East Asia. The "flying geese" paradigm visualizes China and the other Asian countries following behind Japan as the leader in terms of the technological sophistication of its exports. Over the course of two decades, labor-intensive production and exports have moved from Japan, first to the newly industrialized economies of Korea, Singapore, and Taiwan Province of China, then to Indonesia, Malaysia, the Philippines, and Thailand (these last four are known as the ASEAN-4 owing to their membership in the Association of South East Asian Nations), and then to China. Under this paradigm, China and the others are comrades in a process of technological upgrading and of increasing specialization and intraregional trade in Asia. (See Carolan, Singh, and Talati, 1998; and Diwan and Hoekman, 1999.)

The "trade competition" paradigm posits that the East Asian economies and China have ended up specializing in fairly similar export bundles. As a consequence, a major devaluation (a price cut) by one country has an adverse impact on the export performance of other countries and ultimately forces them to devalue their own currencies to maintain their export shares.

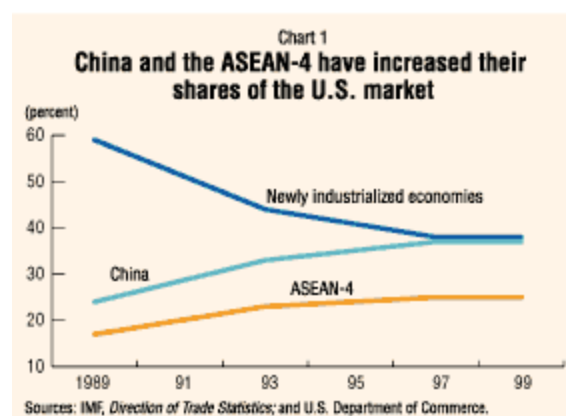
On the face of it, this story has the potential to explain developments in Asia in the 1990s. China's devaluation of the renminbi in 1994 put pressure on the export performance of Thailand and the other crisis-affected countries, leading to devaluations of their currencies during 1997-98; in turn, these devaluations tested the Chinese renminbi's peg to the U.S. dollar and threatened to unleash—in this scenario—a "race to the bottom" in Asia (see Bhalla, 1998).

### Comrades or competitors?

To what extent has China gained market share at the expense of East Asian exporters? And did the devaluation of the renminbi in 1994 provide an impetus to these gains? The analysis described below suggests—in answer to the first question—that China has indeed gained market share in major export markets over the course of the last decade. However, contrary to popular perceptions, China's gains have not come about at the expense of the labor-intensive ASEAN-4 economies. Instead, China and the ASEAN-4 have together displaced the newly industrialized economies in industries—such as apparel, footwear, and household products—that these more advanced economies were relinquishing. This is a healthy, rather than disturbing, development. It mimics an earlier period, when the newly industrialized economies moved into the industries relinquished by a more advanced Japan. Second, the 1994 devaluation did not provide any impetus to China's gains in market share. To the contrary, China's gains occurred, to a large extent, before the devaluation and have moderated substantially since then.

Consider Chart 1, which shows changes in the market shares of China and East Asian economies in one major export market, the United States. In 1989, China accounted for about one-

fourth of total exports to the United States from this group of countries. By 1993, China's share had increased to one-third. The ASEAN-4 group's market share also increased, although by less than China's. Correspondingly, the share of the newly industrialized economies fell from 59 percent to 44 percent.

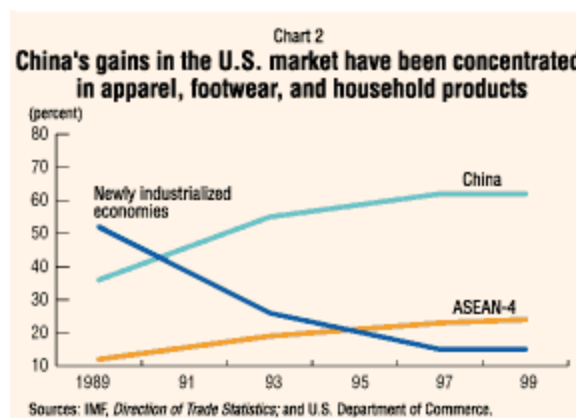


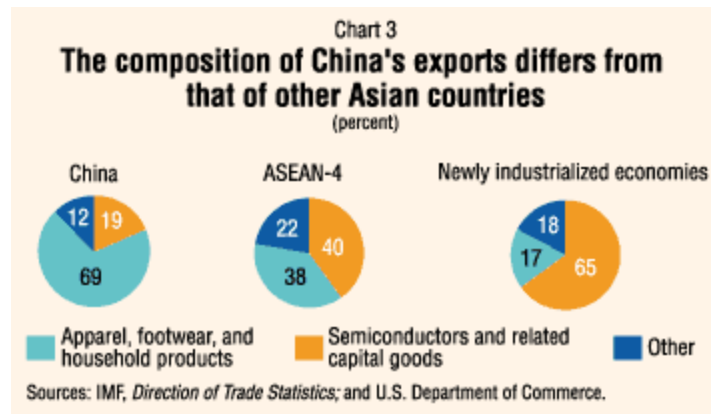
There is, therefore, some evidence of trade competition—shifts in market share—among the three groups over the period 1989 to 1993. (Consistent with this finding, Giorgianni and Milesi-Ferretti (1997) document that Korea lost market share in the countries of the Organization for Economic Cooperation and Development during 1987-97 to China and ASEAN-4 economies, such as Malaysia and Thailand.)

By contrast, the period between 1993 and 1999 was marked by far less competition. The shares of China and the ASEAN-4 inched up over these years at the expense of the newly

industrialized economies. A look at changes in individual industries shows where China's gains are concentrated. The bulk of the gain is in apparel, footwear, and household products. As shown in Chart 2, China's market share in these industries increased dramatically, from 36 percent in 1989 to 62 percent in 1999, with the bulk of this increase occurring between 1989 and 1993. The share of the ASEAN-4 also increased over the period, with the gain being more substantial in the earlier part of the period than in the later part. Over the course of the Asian crisis, market shares in these industries remained constant.

As a result of the evolution in market shares of the kind shown in Chart 2, the composition of China's exports to the United States is quite different from that of the other East Asian economies, as is shown in Chart 3.





Apparel, footwear, and household products account for nearly 70 percent of China's exports, while semiconductors and related capital goods account for about 20 percent. In the newly industrialized economies, these proportions are nearly reversed: semiconductors and related capital goods account for 65 percent of their exports, while apparel, footwear, and household products account for less than 20 percent. The ASEAN-4 countries are an intermediate case: each of the two industry clusters accounts for about 40 percent of total exports. Diwan and Hoekman (1999) also conclude that "the correlations and similarity indices do not suggest that China is a major source of competition for East Asian countries"; in fact, their findings suggest that China's export structure is more similar to that of Portugal or Italy than to that of other East Asian countries.

A similar analysis for other regional markets—Japan and the major European markets—does not alter the basic thrust of the results. The evidence presented in Fernald, Edison, and Loungani (1999) once again suggests that there was greater trade competition in the period 1989 to 1993 than there has been since 1993 and that China's gains have come at the expense of the newly industrialized economies rather than at the expense of the ASEAN-4.

### **Was China the first domino?**

Proponents of the trade competition paradigm assert that a massive 40 percent devaluation of the renminbi in January 1994 triggered the Asian crisis of 1997-98: China, in other words, was the first domino to fall in the Asian crisis.

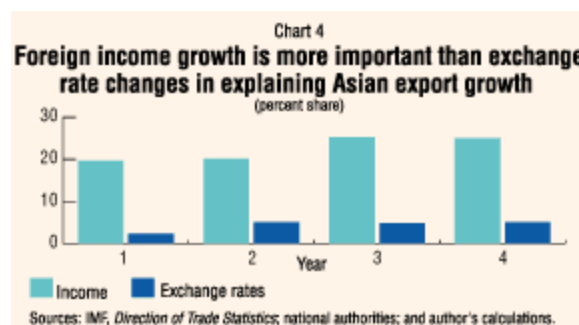
However, the assertion that China engineered a big devaluation of the renminbi in 1994 is questionable. What

China did in January of that year was to unify its official exchange rate with a largely market-determined swap rate. Since most transactions were already being carried out at the more depreciated swap rate, the effective devaluation was much smaller, about 7 percent. Moreover, in real terms (that is, adjusted for inflation), the depreciation rapidly reversed itself because unification took place at a time of rapidly rising inflation in China. And, in any event, as already shown in the analysis above, this devaluation did not accelerate China's gains in market share.

More generally, changes in real exchange rates have not been the primary determinant of export growth for China and the major East Asian exporters. Instead, the most important determinant has been demand from major trading partners (primarily the industrial countries, and the United States in particular). Evidence substantiating this claim comes from an estimation of standard aggregate export equations for these economies—that is, equations expressing real export growth as a function of real income growth of the major trading partners and real exchange rate changes—using annual data from 1973 to 1998. (For details, see Fernald, Edison, and Loungani, 1999.) Drawing on the estimated equations, Chart 4 shows that income effects account for a much larger percentage of the variance of export growth than relative price effects. For instance, at the one-year horizon, income growth accounts for 20 percent of the variance, compared with 2 percent for real exchange rate changes.

The results also point to the importance of factors other than income and relative prices. Two factors are likely to be at work here.

First, export growth can have a substantial "inertial" component because, once a country has incurred the fixed costs of entering a particular market or industry, the country may remain in it despite changes in the other fundamentals. Second, export growth may be helped by structural reforms or tax incentives not captured in this analysis. For instance, in the case of China, examples include allowing local governments and exporting enterprises to retain a proportion of foreign exchange receipts, eliminating mandatory export and import



planning, and opening the economy to foreign direct investment (see Cerra and Dayal-Gulati, 1999).

China and many other Asian countries have a long road ahead of them in implementing critical structural reforms. Concern about the prospects for these economies should be centered on their progress with these reforms, not on unwarranted fears about trade warfare among them.

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